STATEMENT OF SPIRIT AIRLINES, INC.
BY
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BEFORE THE

U.S. SENATE
COMMITTEE ON COMMERCE,
SCIENCE, AND TRANSPORTATION
SUBCOMMITEE ON AVIATION

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SUMMARY OF STATEMENT OF SPIRIT AIRLINES, INC.

GENERAL

At a defining moment in the history of airline deregulation, the major carriers are highly profitable and simultaneously consolidating. Actual competition is decreasing. Potential competition, including a credible threat of low fare entry by new carriers, is vital to the continued success of deregulation.

Thirteen low fare scheduled service "start-ups" together comprised about 3.1% of domestic revenue passenger miles (RPM's) in 1996 and about 3% in 1997. Of the thirteen, four have failed altogether in the last six months. The cumulative losses exceed $350 million. Though Southwest, with 6.41% of domestic 1997 RPM's, continues to do well, it would be foolish to expect a single company to discipline the entire industry or to base national policy on the success or failure of a single company.

THE DOT COMPETITION GUIDELINES

Against this background, the proposed DOT competition policy statement is an important and salutary development. The low fare industry has no prospects for success unless the line between vigorous competition and predatory conduct is drawn in an enforceable manner. Rather than fulminate about "re-regulation," DOT's critics should forthrightly acknowledge whether they engage in or approve of the conduct which DOT describes, and explain why such conduct is beneficial. Congress must insist that criticism of the DOT be constructive.

The DOT guidelines are properly based on antitrust principles. It is to be hoped that current proceedings at the Department of Justice will make an analogous contribution. The more DOJ does to clarify the law, the less required from the DOT. Because pure antitrust remedies are more feared by airline predators than DOT cease-and-desist orders, it is in the interests of competition as well as efficient, minimalist government that DOJ take a greater role upon itself.

INTERNATIONAL ALLIANCES

The merits and demerits of international carrier alliances can be debated from the standpoint of international competition. While they reduce the absolute number of actual and potential competitors, they may in many cases create offsetting efficiencies which would be difficult to achieve under current bilateral arrangements.

What is clear is that these alliances make it harder for Spirit to compete in

the domestic marketplace. There are no longer any United States new entrants with international aspirations, not even Southwest. The scope and scale of these alliances simply dwarfs the competitive capabilities of all but the largest airlines. Nor are smaller U.S. carriers attractive to the international alliances. At Detroit, this means Spirit is competing not just with Northwest, but with KLM as well. Our competitor not only reaps the monopoly "rents" from U.S. government conferred limited designation route awards, it has the feed and revenues from international traffic -- facilitated by antitrust immunity -- as well. Indeed, the need to service this traffic is a reason why Northwest has argued that new gates at Detroit should go to it rather than smaller carriers such as Spirit who have no gates at all.

The alliance phenomenon, therefore, buttresses the need for as level a playing field for domestic new entrants as possible. It is infuriating to hear major carriers describe DOT's competition guidelines as a "subsidy" for new entrants. Plainly, any subsidies go in the other direction, to established carriers. Limited designation route awards, grandfathered slots at the high density airports, exclusive use gates at 1970's-era price levels, and similar government conferred advantages are genuine subsidies from an economic perspective. Having the protection of the antitrust laws is not a subsidy.

> "Anyone who says applying antitrust laws is the same as re-regulation is simply ignorant. To preserve competition we need the antitrust laws and vigorous enforcement of the antitrust laws. If this is regulation, then the whole economy is regulated." Dr. Alfred E. Kahn, as quoted in The Detroit Free Press, April 7, 1998, pg. 6A.

Mr. Chairman, everyone on this panel should agree on one thing: as the Airline Deregulation Act reaches the ripe age of 20 this year, the nation can look back with pride on a truly bipartisan reform. Most analysts have indeed concluded that the net benefits of deregulation outweigh the costs, and that the average traveler is much better off. Having come to Washington with Dr. Alfred E. Kahn twenty years ago to play a small role in the deregulation process, I am proud of this result.

To celebrate a policy success does not, however, require us to ignore unanticipated industry trends, including questionable actions by established carriers to eliminate low fare competitors, whose numbers are rapidly decreasing. Furthermore, tangible "barriers to entry" in the airline business are actually getting higher as time has marched on. You can't fly without a place to land. When essential resources such as airport slots and gates are scarce, entrenched, politically savvy companies, with entire staffs whose purpose is to game the regulatory system in their favor, have an undeniable advantage over new entrants.

All of these problems, which combine with particular intensity at single carrier dominated "fortress hubs," have been well documented in the economic

literature and in any number of GAO and DOT reports. Some major carriers are extremely upset that responsible government officials are actually attempting to deal with these problems, however reluctantly. Unfortunately, some of these carriers are resorting to unsubstantiated and even personal attacks, e.g., that public servants at DOT are "re-regulators" or "enemies of the free market." To the contrary, Congress and the Executive Branch are to be commended as they begin what should be a serious effort to find practical solutions for current problems, cures which are not "worse than the disease" and which actually help travelers and communities. If these hearings could have one desirable result, it would be that the DOT's opponents offer constructive criticism, not spin.

The architects of airline deregulation did not advocate a simplistic *laissez-faire* approach to the marketplace. They firmly believed in the importance of pro-competitive antitrust principles, and clearly intended their enforcement to be a Federal executive responsibility shared by the Departments of Transportation and Justice. The legislative history of the Airline Deregulation Act could not be clearer: "Apart from the encouragement of new entry, the Board [now the Department of Transportation] is given the companion directive to prevent anti-competitive practices and avoid industry and market concentration. . . . Predatory behavior, market concentration and other economic evils should be avoided and remedied." S. Report 95-631, 95th Cong., 2d Session (1978), p. 52

Subsequent events have justified this concern for effective enforcement. Selective citation of incomplete data can not negate the generally accepted

conclusion that concentration in the industry is increasing. In a recent study, "Airline Competition at the 50 Largest U.S. Airports – Update," Salomon Brothers investigated market shares on an airport-by-airport basis (rather than by the customary national averages) and identified "an unprecedented degree of concentration in the airline business." Since that study, Northwest Airlines, the country's fourth largest carrier, has bought a controlling interest in the sixth largest, Continental. According to recent press reports, American Airlines, Delta Airlines, US Airways, and United Airlines, i.e., the vast bulk of the industry by any measure, have been actively discussing how some of them might combine in response. The most recent DOT market share statistics, set forth in Appendix A, show the big getting bigger and wealthier and the small getting smaller and poorer. There is nothing intrinsically wrong with bigness, of course; but those who profess blithe unconcern about these developments are the ones who are encouraging re-regulation of the industry.

Though no one knows what the efficient market structure of the airline industry will ultimately turn out to be, the level of increased concentration mandates a modicum of caution before we assume that oversight of anti-competitive practices is unnecessary. The real issue is not re-regulation vs. deregulation but whether deregulation can ultimately succeed if there is increasing concentration and no new entry into the marketplace. No advocate of deregulation ever dreamed that the industry would evolve without the discipline of actual and potential competition.

What all analysts have shown is that the single most effective competitive discipline arises from entry by a low fare competitor, such as Southwest Airlines. For a while, there were several would-be imitators of Southwest but, since the Valujet crash in 1996, and in the wake of predatory practices by major carriers, the number of these new entrants is swiftly declining. Five have ceased operating in the past year. As set forth in Appendix A, any statistics which purport to show that low fare airlines are doing well or expanding reflect at most the success and growth of a very unique company, Southwest Airlines; remove Southwest from the statistics and the low fare airline industry is miniscule, with less than 3% of total domestic revenue passenger miles (RPM's). We cannot base an entire national aviation policy on the expectation that a single company, whose share of the national market grew but modestly from 6.37% in 1996 to 6.41% in 1997, will discipline the entire industry.

Can public policy help? Relaxing the High Density Rule and taking other steps to increase competitive access for new airlines which did not receive "grandfathered" airport slots and gates simply cannot be construed as re-regulation. We should be suspicious when entrenched carriers defend these entry barriers as their unique entitlement.

The more difficult question is whether public policy should intervene to defend smaller carriers from predatory activities, particularly in the pricing area. Again, it is difficult to see how enforcement of antitrust standards on a timely basis can be deemed re-regulation. Indeed, Section 102 of the Airline

Deregulation Act (now 49 U.S.C. § 40101(a)(9)) expressly requires the prevention by the Department of Transportation of "unfair, deceptive, predatory, or anti-competitive practices in air transportation."

It should be clearly understood that there is no doubt as to whether predatory pricing and capacity dumping actually occurs in the airline business, only whether there is anything that can usefully be done about it. Whatever one might think of dicta in recent Supreme Court predatory pricing cases,[1] neither of them arose in the context of a service industry largely driven by network economics of scale and scope. The classic treatment of airline predation was written in 1987 by then Yale Dean (and now Executive Vice President of Northwest Airlines) Michael E. Levine, who trenchantly parsed the "puzzling persistence of apparently predatory behavior in deregulated airline markets," noting that "economists committed to a high degree of airline market contestability have historically maintained that predation is doomed to failure and is therefore unlikely because the capital assets involved in airline production are mobile." He concluded, "[t]his contestability analysis is unfortunately inconsistent with much observed behavior since deregulation . . . large holdover incumbents are not easily susceptible to predation, but smaller new entrants are." 4 Yale Journal on Regulation, 393, 472-3

In fact, predatory conduct can be remarkably blatant. At Spirit, we are most familiar with competitive conditions at Detroit, our home base. In a

[1] Brooke Group v. Brown & Williamson Tobacco Corp., 113 S. Ct. 2578 (1993) and Matsushita Electrical Industrial Co. v. Zenith Radio Corp., 106 S. Ct. 1348 (1986)

previous statement of my views on this subject to the Transportation Subcommittee of the Senate Appropriations Committee, on March 5, 1998, I recounted some of our experiences, particularly in the Detroit-Philadelphia/Boston markets, competing with Northwest Airlines. If Northwest's actions in throwing us out of those markets is not predation, then there is no such thing as predation. Rather than lengthen this testimony unduly, I am attaching that testimony hereto as Appendix B, for the record.

This Committee should be aware that Northwest continues to pour capacity into markets which Spirit continues to contest. Appendix C shows Northwest non-stop scheduled seats in Detroit-Florida markets form 1994 to the present. In each case, our 1995 entry precipitated a flood of seats, particularly in the Detroit-Orlando (MCO) and Detroit-Fort Myers (RSW) markets. In the latter market, which we have developed assiduously, Northwest has literally doubled its seats over the last year. Mr. Chairman, the message that hub dominant carrier is sending to us is very clear. The message to the travelling public will be equally clear if we choose to leave.

If there is going to be a low fare industry in this country alongside hub dominating "fortress carriers," there is now no choice but to define the line between legitimate, hard-nosed pricing and predatory tactics. This is a difficult but not insurmountable task.

The DOT's proposed Airline Competition Policy Statement (issued April 6, 1998) seems to be directly aimed at the type of egregious behavior outlined

above. The Policy Statement zeros in on three specific scenarios which appear wholly irrational in the absence of predatory intent. The DOT's critics have evidently failed to notice that incumbent carriers remain perfectly free to match a new entrant's fares. They are constrained only in their "right" to add so much capacity at the new low fares that their aggregate gross revenues actually decrease even as the costs incurred in providing the new capacity increase, i.e., the dominant carrier's marginal revenue is either negative or totally disproportionate to its marginal costs. Rather than fulminate against any attempts to define predatory conduct, the critics should explain why carriers would want to do the things the Department would proscribe, if the intent is not predatory.

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One clear conclusion from the alliance phenomenon it, therefore, that it is even more critical to take the necessary steps to have as level a playing field for domestic new entrants as possible. It is infuriating to hear major carriers describe DOT's competition guidelines as a "subsidy" for new entrants. Plainly, any subsidies go in the other direction. Limited designation route awards, grandfathered slots at the high density airports, exclusive use gates at 1970's-era price levels, and similar government conferred advantages are genuine subsidies from an economic perspective. Having the protection of the antitrust laws is not a subsidy.

Mr. Chairman, the 881 employees of Spirit Airlines appreciate this opportunity to appear before you today. We seek only a reasonable opportunity to compete.